INTERNET DOCUMENT INFORMATION FORM

A . Report Title: Management Costs Associated with the Defense Enterprise Fund

B. DATE Report Downloaded From the Internet: 01/10/02

C. Report's Point of Contact: (Name, Organization, Address, Office Symbol, & Ph #): OAIG-AUD (ATTN: AFTS Audit Suggestions)
Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-2884

D. Currently Applicable Classification Level: Unclassified

E. Distribution Statement A: Approved for Public Release

F. The foregoing information was compiled and provided by:
DTIC-OCA, Initials: __VM__ Preparation Date 01/10/02

The foregoing information should exactly correspond to the Title, Report Number, and the Date on the accompanying report document. If there are mismatches, or other questions, contact the above OCA Representative for resolution.

DISTRIBUTION STATEMENT A
Approved for Public Release
Distribution Unlimited

Audit Report

MANAGEMENT COSTS ASSOCIATED WITH
THE DEFENSE ENTERPRISE FUND

Report No. D-2002-033 December 31, 2001

Office of the Inspector General
Department of Defense

20020114 066

AQI 02-04-0624

Additional Copies

To obtain additional copies of this audit report, visit the Inspector General, DoD, Home Page at www.dodig.osd.mil/audit/reports, or contact the Secondary Reports Distribution Unit of the Audit Followup and Technical Support Directorate at (703) 604-8937 (DSN 664-8937) or fax (703) 604-8932.

Suggestions for Future Audits

To suggest ideas for or to request future audits, contact the Audit Followup and Technical Support Directorate at (703) 604-8940 (DSN 664-8940) or fax (703) 604-8932. Ideas and requests can also be mailed to:

OAIG-AUD (ATTN: AFTS Audit Suggestions)
Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-4704

Defense Hotline

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to Hotline@dodig.osd.mil; or by writing to the Defense Hotline, The Pentagon, Washington, DC 20301-1900. The identity of each writer and caller is fully protected.

Acronyms

DEF	Defense Enterprise Fund
FAR	Federal Acquisition Regulation
GPV	Global Partner Ventures, LLC
NIS	Newly Independent States
OMB	Office of Management and Budget
SEED	Support for Eastern European Democracy

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

December 31, 2001

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (STRATEGY AND THREAT REDUCTION)
DIRECTOR, DEFENSE THREAT REDUCTION AGENCY

SUBJECT: Report on the Management Costs Associated With the Defense Enterprise Fund Grant (Report No. D-2002-033)

We are providing this report for your information and use. We considered comments from the Defense Threat Reduction Agency on a draft of this report when preparing the final report.

We appreciate the courtesies extended to the audit staff. For additional information on this report, please contact Ms. Evelyn R. Klemstine at (703) 604-9172 (DSN 664-9172) (eklemstine@dodig.osd.mil) or Mr. Donney J. Bibb at (703) 604-9613 (DSN 664-9613) (dbibb@dodig.osd.mil). See Appendix D for the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

David K. Steensma
Acting Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. D-2002-033 **December 31, 2001**
(Project No. D2000LG-0031.02)

Management Costs Associated With the Defense Enterprise Fund

Executive Summary

Introduction. This report is being issued to provide lessons learned for managing enterprise funds. The Cooperative Threat Reduction Program was initiated in FY 1992 to reduce the threat posed by weapons of mass destruction remaining in the former Soviet Union. In June 1994, DoD established the Defense Enterprise Fund to assist Belarus, Kazakhstan, Russia, and Ukraine in the privatization of defense industries and conversion of military technologies and capabilities for civilian use.

The National Defense Authorization Act for fiscal year 1994, section 1204 (22 U.S.C. 5953), authorized the President to designate Demilitarization Enterprise Funds to receive grants and use those grants for financially supporting demilitarization of industries and converting military technologies and capabilities to civilian activities. The law required that the President consult with the Department of State and the U.S. Agency for International Development to ensure that the terms of any such grants were consistent, to the maximum extent practicable, with grants awarded to enterprise funds established under the Support for East European Democracy Act of 1989 (Public Law 101-179 [22 U.S.C. 5421]). The authority and requirements established under the National Defense Authorization Act for fiscal year 1994, section 1204, were subsequently delegated to the Secretary of Defense. The Defense Enterprise Fund was created under the authority delegated to the Secretary of Defense.

The DoD and Department of State provided funding of $66.7 million to the Defense Enterprise Fund through a grant. Inspector General, DoD, Report No. D-2000-176, "Defense Enterprise Fund," August 15, 2000, discusses reasons why the value of investments decreased from $38.3 million to $31.3 million* as of March 2000. As of September 30, 2000, the total value of the Defense Enterprise Fund was $15.2 million, including $11.0 million of investments.

Office of Management and Budget Circular No. A-122, "Cost Principles for Non-Profit Organizations," is a regulation used by Government agencies to determine which expenses incurred by non-profit organizations can be charged to Government awards. That regulation was not included as a requirement in the grant to the Defense Enterprise Fund to be consistent with grants awarded to enterprise funds established under the Support for East European Democracy Act of 1989. Those grants did not include Office of Management and Budget Circular No. A-122 as a grant requirement. To be

*Although the Inspector General, DoD, report shows the value of Defense Enterprise Fund investments to be $31.3 million as of March 2000, the audited financial statements of the Defense Enterprise Fund for the fiscal year ending September 30, 1999, indicate that investments decreased to $14.9 million. Also, according to the audited financial statements, the net value of the Defense Enterprise Fund as of September 30, 1999, was $17.5 million.

chargeable to Government grants based on Office of Management and Budget Circular No. A-122, expenses must be reasonable, allocable to the grant, consistent with organization policies and procedures, and accorded consistent treatment. Expenses are allocable if they were incurred for the award, benefit both the award and other work, and can be distributed in reasonable proportion to the benefits received, or were necessary to the overall operation of the organization.

Objectives. Our overall audit objective was to evaluate how the Defense Enterprise Fund and its fund manager, Global Partner Ventures, LLC, used grant funds for managing the grant. In addition, we evaluated whether the terms of the grant provided to the Defense Enterprise Fund were consistent with grants awarded to enterprise funds established under the Support for East European Democracy Act of 1989.

Results. Through FY 2000, the Defense Enterprise Fund and Global Partner Ventures, LLC, used at least $35.6 million of grant funds and income from grant funds for management costs and expenses in conformance with the grant agreement. That amount included $32.4 million expended by the Defense Enterprise Fund and Global Partner Ventures, LLC, between FY 1994 and FY 1999, the period covered by our review. As required by National Defense Authorization Act for fiscal year 1994, the terms of the grant to the Defense Enterprise Fund were generally consistent with the terms of grants awarded under the Support for East European Democracy Act of 1989. As a lessons learned, had statutory authority allowed DoD to incorporate cost principles for Federal grants into the grant agreement, the grants officer could have determined that management costs and expenses totaling at least $2.2 million to be unallocable, unallowable, or unreasonable.

Management Actions. Because DoD was required to follow the terms of grants awarded under the Support for East European Democracy Act of 1989 and the Defense Enterprise Fund subsequently awarded a firm-fixed-price contract in October 1999 valued at $2 million a year, to manage its investments, this report contains no recommendations.

Management Comments. The Defense Threat Reduction Agency comments to the draft report emphasized that DoD does not control the Defense Enterprise Fund and stated that Congress declined to impose Federal regulations on the Defense Enterprise Fund. In addition, the Defense Threat Reduction Agency noted that it prepared the grant according to specific legislative requirements. Also, the Defense Threat Reduction Agency stated that the Defense Enterprise Fund was chartered to use grant funds to organize its management company and raise private capital. The Defense Threat Reduction Agency suggested that the lead sentence in the Executive Summary of this report state that the Defense Enterprise Fund used funds according to the terms of the grant.

A discussion of management comments is in the Finding section of the report and the complete text is in the Management Comments section.

Table of Contents

Background

The Defense Enterprise Fund (DEF) was established under section 1204 of the National Defense Authorization Act for fiscal year 1994, Public Law 103-160 (22 U.S.C. 5953). The DEF is a private not-for-profit corporation that makes investments devoted to defense conversion.[1] Initially, the Defense Nuclear Agency, renamed the Defense Special Weapons Agency in June 1996, had oversight responsibility for the DEF. Since September 30, 1998, the Cooperative Threat Reduction Program Directorate, a component of the Defense Threat Reduction Agency, has had oversight responsibility for the DEF.

Grant Funding. DoD provided funds to the DEF through Grant No. DNA001-94-J-0004 dated June 21, 1994. As of April 2001, DoD had funded the grant for $66.7 million, including $15 million transferred from the Department of State in FY 1997 under the Freedom Support Act. In addition to those appropriated funds, section 1204(f) of the National Defense Authorization Act for fiscal year 1994 authorized the DEF to use interest earned on the appropriated funds for program purposes.

DEF Activities. The purpose of the DEF grant is to provide financial support for commercial initiatives in eligible states of the newly independent states (NIS) of the former Soviet Union that facilitate demilitarization of defense industries and conversion of military technologies and capabilities to civilian activities. NIS countries eligible for assistance include Belarus,[2] Kazakhstan, Russia, and Ukraine. The grant allows the DEF to invest in joint business initiatives involved in converting the defense sector in the NIS. Those initiatives are to include former Soviet Union business partners formerly engaged in producing or supporting weapons of mass destruction or other defense-related endeavors and at least one western business partner. Investments include loans and equity investments.

The grant states that the DEF could use revenue that it generates to pay expenses and to invest in new projects and activities in the NIS. The grant also states that the DEF could establish, invest in, or finance subsidiaries or other entities whose primary business is to make investments or loans or to provide financial services, with the prior written approval of the Defense Nuclear Agency.[3] Approval is based on the consistency of the business purpose and investment policies and practices with those of the DEF and the extent to which the requirements of the grant apply to that entity.

[1]Defense conversion is the transition of personnel or facilities that were formerly involved in research, development, production, or operation and support of the defense sector to peaceful civilian activities.

[2]The DEF has not invested in Belarus since FY 1997 because of human rights violations.

[3]The provision allowed the DEF to finance the establishment of Global Partner Ventures, LLC.

Managing DEF Investments. Initially, DEF employees managed fund investments. In December 1997, the grant officer for the Defense Special Weapons Agency approved the transfer of fund management to Global Partner Ventures, LLC (GPV), and in February 1998 that arrangement was finalized with a contract that was awarded noncompetitively. GPV, a for-profit company, was owned by two DEF employees, one of whom retained the position as president of the DEF after the transfer. GPV purchased DEF assets at book value.[4] In forming GPV, the DEF employees were expecting to attract private capital and establish other funds. The DEF was expected to benefit from GPV expansion efforts because overhead costs would be allocated between DEF projects and projects of the private fund. Although the contract between the DEF and GPV ran through September 2000, the DEF purchased GPV in July 1999. In October 1999, the DEF awarded a noncompetitive contract to another for-profit company, Siguler Guff and Company, LLC, a New York-based investment manager, to manage the fund through FY 2004. The contract with Siguler Guff and Company, LLC, is a firm-fixed-price contract for 5 years and valued at $2 million a year. According to a former chief financial officer for the DEF and GPV, Siguler Guff and Company, LLC, was one of the few private investment firms doing business in Russia after the decline of the Russian economy in 1998.

Managing investments of the DEF consists of various activities, to include:

- Monitoring the status of DEF investments;
- Consulting with companies in which the DEF has invested and providing advise on financial and operational management strategies;
- Planning and negotiating to maximize the value of DEF investments; analyzing, identifying, performing due diligence, and structuring and negotiating new DEF investments in the region or, making additional investments in companies in which the DEF has invested; and
- Working with the DEF to attract private capital for investment in the region, to the extent that economic conditions in the region permit.

Management Costs. Between FY 1994 and FY 2000, the cost of managing the fund totaled more than $35.6 million, of which $32.4 million was incurred between FY 1994 and FY 1999 when DEF employees and GPV managed the fund. Management costs for the fund through FY 2000 are summarized in Appendix B. The scope of our review of management costs was limited to costs shown in the DEF and GPV general ledgers for FY 1997, FY 1998, and

[4]Book value is the residual value of an entity's assets after deducting its liabilities. In report GAO/OGC-99-61R, "Foreign Assistance: Issues Concerning the Polish-American Enterprise Fund," September 14, 1999, the General Accounting Office reviewed a similar arrangement regarding the Polish-American Enterprise Fund. The General Accounting Office concluded that the sale to employees at book value was consistent with law and that sale terms were reasonable. The General Accounting Office agreed with officials from the U.S. Agency for International Development and Department of State who stated that limiting the valuation of the Polish-American Enterprise Fund was needed to preserve the continuity of staff, which was critical to the success of the fund.

FY 1999. In addition, the scope was limited to DEF and GPV records provided by the DEF General Counsel and at the New York offices of the current fund manager. Details of the scope limitations are in Appendix A.

Under terms of the grant, the cost of managing the DEF was paid from grant funds. Also, the contract between the DEF and GPV called for GPV to be paid the costs that it incurred. Specifically, the contract states that the DEF will pay a management fee to GPV in advance, calculated to cover expenses. If the advance fees exceeded expenses, the DEF was to deduct the excess from the management fee paid in the next funding period.

The FY 1998 budget for GPV describes the financial relationship between the DEF and GPV. The budget states that the DEF would fund GPV by paying a fee to GPV for managing DEF investments and by paying GPV for its capital expenditures and lease prepayments. GPV was to use the management fee to fund its costs. Those costs included salaries and benefits for GPV employees in Richmond, Virginia, Moscow, Russia, and St. Petersburg, Russia; marketing and communications; amortization and depreciation; and the startup activities for the NIS Transformation Fund, a private equity fund created by GPV.

Objectives

Our overall audit objective was to evaluate how the DEF and its fund manager, GPV, used grant funds for managing the grant. In addition, we evaluated whether grant terms were consistent with grants awarded to enterprise funds established under the Support for East European Democracy Act of 1989 (SEED Act), Public Law 101-179.

Use of Grant Funds to Manage Investments

As required by National Defense Authorization Act for fiscal year 1994, the terms of the grant to the DEF were generally consistent with the terms of grants awarded under SEED Act. Through FY 2000, the DEF and GPV used at least $35.6 million of grant funds and income from grant funds for management costs and expenses in conformance with the grant agreement. That amount included $32.4 million expended by the DEF and GPV between FY 1994 and FY 1999, the period covered by our review. As a lessons learned, had statutory authority allowed DoD to incorporate cost principles for Federal grants into the grant agreement, the grants officer could have determined that management costs and expenses totaling at least $2.2 million[5] to be unallocable, unallowable, or unreasonable.

Establishing the DEF

Legal Requirements. The National Defense Authorization Act for fiscal year 1994, section 1204 (22 U.S.C. 5953), authorized the President to designate a Demilitarization Enterprise Fund to receive grants and use those grants to financially support demilitarization of industries and convert military technologies and capabilities to civilian activities. The law required the President to consult with the Secretary of State and the Administrator of the U.S. Agency for International Development to ensure that the terms of any such grants were consistent, to the maximum extent practicable, with grants awarded to enterprise funds established under the SEED Act. The authority and responsibilities established under the National Defense Authorization Act for fiscal year 1994, section 1204, were subsequently delegated to the Secretary of Defense. The DEF was created under the authority delegated to the Secretary of Defense.

Polish-American Enterprise Fund. The terms of the DEF grant generally paralleled the terms of Grant No. ANE-0010-G-00-0022-00 awarded to the Polish-American Enterprise Fund, a SEED Act grantee, by the U.S. Agency for International Development. Under the terms of both the DEF and Polish-American Enterprise Fund grants, grantees could use funds to support costs that are reasonable and allowable according to the terms of the grant and the statement of corporate policies and procedures. There were, however, three operating differences between the DEF and Polish-American Enterprise Fund. First, DEF investments were limited to $8 million, unless DoD approved a higher amount, whereas the grant for the Polish-American Enterprise Fund did not restrict the amount of individual investments. Second, DoD provided funds to the DEF in advance of its immediate cash needs, whereas the

[5]As discussed in Appendix A, Audit Process, there were several limitations to the scope of the audit.

Polish-American Enterprise Fund operated under a letter of credit with the U.S. Agency for International Development and could only draw cash needed for 30 days. Third, the DEF was required to pursue investments in all eligible countries with target investments of at least 25 percent in Russia, 20 percent in Ukraine, 10 percent in Kazakhstan, and 5 percent in Belarus. Performance of the DEF was to be evaluated against those target investments. The Polish-American Enterprise Fund targeted its investments on small and medium size enterprises in Poland.

Applying Federal Cost Principles

Like grants awarded under the SEED Act, the DEF grant did not incorporate the cost principles of Office of Management and Budget (OMB) Circular No. A-122, "Cost Principles for Non-Profit Organizations." According to an official from the U.S. Agency for International Development, which administers SEED Act grants, OMB Circular No. A-122 requirements were excluded from SEED Act grants to emulate private industry and free grantees from the "red tape" that typically accompanies grants. The official from the U.S. Agency for International Development also stated that independent accounting firms hired to audit grantee financial statements were expected to report any irregularities to the grantee board of directors. Rather than focus on cost, the official from the U.S. Agency for International Development stated that his agency compared the cost of managing enterprise funds against the size of the investment portfolio. Annual management costs that range between 1 percent and 2 percent of the investment portfolio were acceptable.[6]

The DEF grant, like the grant to the Polish-American Enterprise Fund, states that funds provided under the grant can be used to support costs that are reasonable and allowable according to the grant terms and the Statement of Corporate Policies and Procedures for the organization. Neither grant discusses the allowability of specific costs. Except for information in the DEF Statement of Corporate Policies and Procedures, which includes several types of costs that are not allowable under OMB Circular No. A-122, the independent accounting firm would not have a basis for evaluating whether specific costs were reasonable.

Had DoD been allowed to include OMB Circular No. A-122 in the DEF grant, management costs charged to the grant by GPV through its contract with the DEF would have been subject to the cost principles in the Federal Acquisition Regulation (FAR). Specifically, paragraph 3.b. of OMB Circular No. A-122 requires subgrants and cost reimbursable subcontracts to be subject to the cost principles that apply to the subgrantee or subcontractor. For example,

[6]Using the U.S. Agency for International Development standard for the Polish-American Enterprise Fund to evaluate the cost of managing the DEF between FY 1994 and FY 2000 may be flawed because the Polish-American Enterprise Fund was more mature and the DEF was required to make investments in several countries of the former Soviet Union.

commercial organizations that receive cost-reimbursable subcontracts are required to comply with the cost principles in Part 31 of the FAR, "Contract Cost Principles and Procedures."

Policies and Procedures

DEF Policies and Procedures. We located three DEF documents on policies and procedures related to its finances--the Statement of Corporate Policies and Procedures, dated May 26, 1994; the Corporate Finance Manual, dated July 20, 1995 (revised, effective January 31, 1996); and a draft Policy for Relocation Assistance, dated February 17, 1997.

The Statement of Corporate Policies and Procedures for the DEF includes policies and procedures for accounting, auditing, budgetary and financial controls; ethics and personnel matters; management; recordkeeping; security; and grant funds. The policies and procedures include several categories of expenses that are not allocable or allowable to grants subject to OMB Circular No. A-122. Those expenses include advertising, bad debts, entertainment, and fines and penalties assessed to the DEF. The policies and procedures allowed both the DEF president and DEF board of directors to fly in first class accommodations for domestic and international flights.

The Corporate Finance Manual includes policies and procedures for financial reporting and analysis. The manual has several expense categories that would not be allocable or allowable to grants subject to OMB Circular No. A-122, including business meals and entertainment. The Corporate Finance Manual allows DEF employees to fly business class on nonstop flights that exceed 5 hours, including international travel, as well as to fly first class when the employees are required to attend a meeting shortly after arriving at their destination.

The draft Policy for Relocation Assistance discusses policy for relocating employees within the United States and overseas. For employees relocated overseas, the draft policy states that employees will receive two round-trip economy class tickets each year either to or from the United States. Tickets from the United States were for individuals to visit DEF employees. Although it does not include specific coverage related to employees stationed overseas, OMB Circular No. A-122 states that total compensation costs are allowable to the extent that they are reasonable and conform with the established policy of the organization, consistently applied to Federal and non-Federal activities.

GPV Policies and Procedures. From available records, we identified one GPV policy and no GPV procedures. The policy was a draft International Assignment/Relocation Policy of Global Partner Ventures, LLC, dated September 30, 1997, and published before GPV was organized. For international assignments, the draft policy states that salaries will be based on the compensation structure in each employee's home country, employees are entitled to cost-of-living allowances, and holiday and vacation schedules based on holidays and vacation schedules in effect at the location of assignment. For

employees and their families, the draft policy provides for cross-cultural training, language lessons, physical examinations, familiarization and house hunting visits, and shipping costs for household goods and personal effects. The draft policy does not address whether employees relocated to overseas locations receive airfares for returning to the United States.

Management Expenses

The DEF and GPV used at least $2.2 million of grant funds for costs that would have been unallocable or unallowable if the grant was subject to Federal cost principles, or could have been considered unreasonable and for purposes unrelated to managing the fund. Unallocable expenses included those expenses associated with establishing GPV and its private equity fund. Also, many costs associated with establishing GPV and the private equity fund are unallowable under Federal cost principles, including advertising and public relations, fund raising, and organization. Other expenses, such as business and first class airfares, entertainment, and meals are also unallowable under Federal cost principles. Unreasonable expenses included housing allowances that exceed allowances developed by the Department of State for Government employees, pension expenses that exceed industry averages, and unreasonable training costs. Costs that appear unrelated to managing the fund include personal loans, employee medical expenses, and airfare for vacations. Unallocable, unallowable, and unreasonable expenses are summarized in the following table.

Unallocable, Unallowable, and Unreasonable Expenses
(thousands)

Unallocable	
Organization costs	$1,100.0*
Subtotal	**1,100.0**
Unallowable	
Airfares	29.5
Entertainment and meals	192.6
Subtotal	**222.1**
Unreasonable	
Housing allowances	258.6
Pension contributions	537.4
Training	35.5
Subtotal	**831.5**
Total	**$2,153.6**

*Includes unallowable expenses.

Unallocable Costs. Based on the records provided, between FY 1997 and FY 1999 the DEF incurred at least $1.1 million[7] of costs and expenses that would have been unallocable if the grant were subject to Federal cost principles. Costs and expenses were related to organizing GPV and starting the NIS Transformation Fund. Those costs included accounting, depreciation, fringe benefits, salaries, training, and travel. Expenses that relate to organizing GPV and starting the private equity fund would not normally be allocable to the grant because the DEF allocated similar types of expenses incurred to manage DoD funds directly to the grant. Therefore, similar costs that the DEF incurred related to other cost objectives[8] normally would not have been allocable to the grant with DoD. A detailed explanation and a schedule of those costs and expenses are in Appendix C. According to a May 5, 1998, letter from the DEF counsel to the General Accounting Office, the GPV was to be reimbursed up to $1 million for organizing the NIS Transformation Fund. Therefore, the DEF expected to be reimbursed for most of the expenses that it incurred to raise private capital for the NIS Transformation Fund.

Cost Allocation Principles. Both OMB Circular No. A-122 and the FAR discuss the allocability of costs to Federal awards, including grants, contracts, and cooperative agreements. Attachment A, General Principles, to OMB Circular No. A-122 states that expenses charged to awards must be reasonable, allocable, consistent with organization policies and procedures, and accorded consistent treatment. Attachment A to OMB Circular No. A-122 also states that costs are allocable to Federal awards if they are incurred specifically for the award; benefit the award and other work, and can be distributed in relationship to the benefits received; or are necessary to the overall operation of the organization. In general, consistent treatment refers to consistency in allocating similar type costs directly to activities, such as awards, projects, or service, or as overhead. Part 31 of the FAR provides similar criteria for allocating expenses to Federal contracts.

Organization and Fund Raising Costs. In addition to being unallocable, at least $503,600 of the costs related to organizing GPV and raising funds for the NIS Transformation Fund would have been specifically unallowable if the grant were subject to Federal cost principles. The unallowable costs include at least $42,500 in legal expenses for organizing GPV and preparing the private placement memorandum[9] for the NIS Transformation Fund, and $460,400[10] in consulting fees for the private investment fund. One

---

[7]This amount does not include overhead costs for overall management of the DEF and GPV. However, the DEF and GPV had not established any apparent method of allocating those costs to its final cost objectives. Also, although expenses for several employees were charged to NIS Transformation Fund accounts, employee salaries were not charged to those accounts.

[8]Attachment A, paragraph B.1. of OMB Circular No. A-122, describes a cost objective as an award, project, service, or other direct activity of an organization.

[9]A private placement memorandum is the primary document that a business uses to raise funds through the issuance of securities. It details the reasons funds are being raised, and identifies the officers and directors, restrictions on the resale of the securities, and any sales commissions.

[10]This amount excludes consulting services in FY 1999 because the DEF general ledger provided did not include sufficient detail to identify consulting fees related to the private equity fund.

consultant was paid to coordinate marketing efforts for placing venture capital funds, selecting other consultants to help raise funds for the NIS Transformation Fund, and directing GPV public affairs and relations for raising funds and building the profile of GPV as a leading venture capital firm. The DEF also reimbursed GPV more than $700 for an employee to play golf at a prestigious resort.

Cost Principles. Both OMB Circular No. A-122 and the FAR restrict the allowability of charging advertising and public relations, and organization and fund raising costs to Government awards. Specifically, Attachment B, paragraph 1 of OMB Circular No. A-122 and FAR Subpart 31.205-1 on advertising and public relations costs, state that those costs are unallowable unless specifically required by contract or grant, or arise from requirements of Government awards. Also, Attachment B, paragraph 31 of OMB Circular No. A-122 and FAR Subpart 31.205-27 on organization costs, state that those costs and fund raising costs are unallowable.

Unallowable Expenses. The DEF and GPV incurred $222,100[11] of expenses that would have been unallowable if the grant were subject to Federal cost principles. Those expenses included airfares in excess of coach class fares, entertainment, and meals for employees who were not in travel status.

Airfares. During Fiscal Year 1999, GPV used $29,500 of grant funds for airfares that would be unallowable because the class of the fare exceeded coach class fares and without documenting the justification. The airfares were for six trips, including five airfares for the two employee-owners of GPV.[12] Although the DEF Statement of Corporate Policies and Procedures allows its president and members of the board of directors to fly first class on domestic and international flights, without documenting adequate justification, those expenses would not have been allowable costs on Federal contracts and grants subject to OMB Circular No. A-122 and the FAR. Also, the Corporate Finance Manual for the DEF allowed employees to fly business class on international flights longer than 5 hours. In contrast, the comptroller for the current fund manager stated that company policy requires that all employees, including the managing partner, fly coach class.

Both OMB Circular No. A-122 and the FAR restrict the allowability of airfares. OMB Circular No. A-122, Attachment B, paragraph 55, on travel costs states that first class airfares are an unallowable cost, and contains the same exceptions provided under the FAR. Further, an OMB official responsible for OMB Circular No. A-122 believed that the OMB cost principle was written before business class airfares were available. The OMB official stated that individual Federal agencies can consider airfares that exceed coach class to be unreasonable. Subpart 31.205-46 of the FAR on travel costs generally disallows airfare costs in excess of the lowest customary standard airfare. Exceptions to the requirement would be when circumstances are such that using the lowest

[11]Although this figure includes the entire cost of business class and first class airfare, only the difference in price between those fares with coach class fares would be unallowable costs.

[12]One of the employee-owners also served as the president of the DEF at that time.

customary standard airfare would require a circuitous route, or for travel during unreasonable hours, result in increased costs that would offset transportation savings or would not meet the medical needs of the traveler. The FAR requires that those circumstances be documented and justified.

Entertainment and Meals. Between FY 1997 and FY 1999, the DEF and GPV incurred at least $192,600 for meals and entertainment, including the cost of a country club membership, employee lunches at their Moscow and St. Petersburg offices, a subscription to the symphony, tennis fees, and theater tickets. In November 1997, the DEF paid about $96,800 for a membership to a country club, including $85,000 for the initial membership fee and about $1,800 in yearly dues for employees. Also, in August 1998, the DEF reimbursed GPV $10,000 for yearly dues to the country club for GPV employees.[13] The DEF and GPV also spent about $50,800 for employee lunches in the Moscow and St. Petersburg offices, excluding the cost of kitchen facilities and office space, and an additional $45,000 for entertainment and meals when employees were not traveling. The entertainment and meals, which included business meetings either with other GPV employees or non-GPV contacts, also included theater tickets costing $500 and tennis fees of $300. In addition, GPV employees benefited from various social activities funded by the grant. For example, in July 1998, GPV purchased an office subscription to a symphony in Moscow for about $900.

Cost Principles for Entertainment. Both Attachment B, paragraph 14, of OMB Circular No. A-122 and Subpart 31.205-14 of the FAR on entertainment costs state that entertainment costs are unallowable. Both regulations specifically disallow the cost of amusement, diversions, social activities, and associated costs such as gratuities, lodging, rentals, and transportation. The FAR subpart also disallows the costs for memberships at country clubs, or dining and social clubs, and specifically identifies tickets to shows or sports events and meals as costs associated with amusement, diversions, and social activities. Attachment B, paragraph 30, of OMB Circular No. A-122 on membership costs, also states that the cost of country club, or dining and social club memberships, is unallowable.

Cost Principles for Employee Meals. Both OMB Circular No. A-122 and the FAR generally disallow the cost of employee meals. Attachment B, paragraph 14, of OMB Circular No. A-122, on entertainment costs states that the cost of meals is unallowable. Also, FAR Subpart 31.205-13 on employee morale, health, welfare, food service, and dormitory costs and credits, states that the cost of food service is unallowable if furnished without charge or at prices or rates that obviously would not sustain a break-even objective.

Unreasonable Costs. The DEF and GPV incurred at least $831,500 of expenses that could be considered unreasonable. Expenses include housing

[13]The comptroller for Siguler Guff and Company, LLC, stated that although the DEF maintains the country club membership, no additional membership payments have been made and the membership is for sale.

allowances that exceeded the allowances provided by the Department of State for Government employees, pension expenses that exceeded industry averages, and expensive training costs.

Housing Allowances. Between July 1997 and September 1999, the DEF paid more than $258,600 for housing six expatriate employees[14] in amounts that exceeded levels that may be considered reasonable based on housing allowances provided by the Department of State for its employees stationed in Moscow. Of that amount, one employee received $142,500 for housing allowances in excess of the Department of State allowances. In addition, the housing allowance provided to that employee may have exceeded DEF and GPV policy by up to $51,425. According to a former DEF and GPV Chief Financial Officer, housing allowances were based on an internal housing allowance schedule. The schedule shows that senior executives with three children were to receive an annual housing allowance of $105,000, which is approximately the housing allowance provided to the employee. Documents in the employee's personnel file, however, indicate only two children, one of whom was more than 17 years of age and attending school full time in the United States.[15] Based on the housing allowance schedule for two children, the employee should have received only $90,000 a year and only $75,000 a year for one child.

Although no criteria was in the grant for determining the reasonableness of housing allowances, the grants officer at the Defense Threat Reduction Agency provided guidelines to the Chairman of the DEF board of directors in March 1999. That time period was about 5 years after the grant started and 2 years after the DEF and GPV began providing housing allowances to expatriate employees. Specifically, the grants officer stated that the DEF should rely on the Department of State Indexes of Living Costs Abroad, Quarterly Allowances, and Hardship Differentials for structuring a fringe benefits package for its own employees and in approving packages for GPV employees. According to Department of State guidelines, the maximum housing allowance for Moscow is $27,500 a year.

Pension Expenses. Based on data published by the Bureau of Labor Statistics, between FY 1997 and FY 1999, DEF and GPV contributions to employee pension accounts may have been $537,400 more than amounts considered reasonable. During that period, the DEF and GPV contributed 19 percent of salaries to pension accounts for employees, about $729,400. That contribution rate significantly exceeded contribution rates published by the Bureau of Labor Statistics. For March 2001, the latest period available, the Bureau of Labor Statistics reported that employers in the finance, insurance, and real estate industry contributed 5 percent of salaries and wages for employee retirement and savings plans. Compared with that national data, the DEF and GPV contributed almost four times the contributions made by employers in the financial, insurance and real estate industry.

[14] We judgmentally selected the employees.

[15] The housing allowance sheet did not indicate if or when children more than 17 years of age were considered for determining the housing allowance.

In a March 1995 memorandum to the DEF Board of Directors, the Chief Financial Officer for the DEF explained the high contribution rate (proposed as 18.5 percent) as part of an employee benefits package[16] that totaled 30 percent of salaries. In the memorandum, the Chief Financial Officer stated that in considering and producing plan documents, DEF managers obtained advise from an accounting firm, legal advisors, and retirement plan advisors. Further, the Chief Financial Officer offered the following explanation for providing the level of employee benefits.

> . . . industry standards, 501(c)(3) organizations [non-profit organizations] tend to provide higher benefits because of salary caps and the lack of long term incentive programs (i.e. stock plans and stock options, etc.) in a not-for-profit environment, [and] the limited life of the organization.

The Chief Financial Officer also offered a comparison of the total benefits for DEF employees against other enterprise funds and stated that other SEED Act grantees had comparable benefit rates. Specifically, the Chief Financial Officer stated that the Russian American Enterprise Fund provided benefit rates of between 25 percent and 27 percent, and the Fund for Large Enterprises in Russia provided benefits of 20 percent to 25 percent, as well as paid the incremental costs of self-insuring its disability obligations.

The March 1995 memorandum shows that the proposed benefits package exceeded the benefits paid by two other enterprise funds by at least 3 percent. Also, when it took over as fund manager, GPV did not have the same constraints as the DEF. Specifically, employees could earn more than $150,000 a year and share in profits, as long as the additional compensation did not come from the grant. Also, the life of GPV was limited only by an ability to succeed in business and a willingness of the owners to stay in business. In addition, the comptroller for the current fund manager stated that the company only guarantees a 4-percent contribution rate but may contribute up to another 5 percent, rather than paying a cash bonus to employees. The controller also characterized the contribution rate for his company as generous.

Training. In June and July 1998, a GPV employee, who may have been transitioning his residence from the United States to Moscow,[17] attended a management course in England in June and July 1998 at a cost of more than $35,500. The training expenses included $27,400 for the course and $8,100 for airfare, lodging, meals, and incidentals. We could identify no documentation to show that the course included unique materials or instruction that was unavailable domestically or that would otherwise justify that particular employee's attendance.

---

[16]Other benefits in the 30 percent benefit package included life, medical, and disability insurance. Leave and employer share of social security were excluded from the 30 pecent rate.

[17]The employee started receiving a housing allowance for an apartment on July 1, 1998, although he was in England from June 21, 1998 through July 18, 1998. Other documents, such as payroll records, that showed when the employee officially became a resident of Russia, were not provided.

Disbursements Unrelated to Managing the Fund. Additional unreasonable cash disbursements and expenditures include those that may not be related to managing the fund. Items included medical expenses, a personal loan, and vacations.

Medical Expenses. In addition to providing health insurance, GPV paid more than $2,600 of other medical and dental expenses for its Russian national employees in FY 1998 and FY 1999. According to memorandums prepared by the employees, payments appear to have been made on a case-by-case basis. Specifically, in the memorandums employees would ask GPV management to pay medical or dental bills not covered by employee insurance. Because GPV provided medical insurance and medical and dental payments were on a case-by-case basis, the payments do not appear to be part of a self-insurance plan set up by GPV. Therefore, the expenses appear to be unnecessary for managing the fund.

Personal Loan. In November 1997, the DEF made a $15,000 loan to the general director of a DEF investment partner and his wife. The purpose of the loan was not stated in the loan agreement. According to the loan agreement, interest was not charged for the first 30 days. After the first 30 days, interest was charged at an annual rate of 8 percent. Although the loan was secured by the salary of the general director and by collateral in shares of stock, the accounting records provided do not show the loan was repaid.

Airfares for Employee Vacations. In addition to home leave, in FY 1999, GPV incurred more than $4,000 of expenses in airfares for a Moscow-based employee and family to take three vacations. Although the travel was not for return trips to the United States, GPV accounted for those expenses as family leave. The airfares included more than $2,500 for a trip to the Middle East and more than $1,500 for two trips to Glasgow, Scotland. The airfares were not directly associated with the objectives of the grant agreement and were not included in any internal DEF or GPV policy. Therefore, the costs of employee travel for vacations are not allowable per the terms of the grant.

Impact on Investments

The DEF expended $35.6 million of grant funds and income from grant funds to manage its investments. The primary expenses included management fees (31.9 percent), consulting expenses (18.5 percent), salaries and compensation (14.4 percent), and accounting, legal and professional fees (13.3 percent). Between FY 1997 and FY 1999, at least $2.2 million of the $35.6 million could have been used to make additional investments in defense conversion activities in eligible states of the former Soviet Union. The Government paid for the DEF to establish GPV and market its private investment fund, airfares that exceeded coach class fares, entertainment, and employee lunches. Also, the Government paid for unusually high contribution rates into retirement plans and housing allowances that exceeded Department of State rates. Those and other expenses could have been used to make additional investments in defense conversion.

According to the comptroller for Siguler Guff and Company, LLC, the business model for managing the fund was flawed. Specifically, the comptroller stated a fund management agreement based on reimbursing the costs of the fund manager provides little incentive for the fund manager to control costs. The comptroller's comments are generally supported by the FAR. FAR Subpart 16.104 on selecting contract types states that when there is effective price competition, a fixed-price contract is ordinarily in the best interest of the Government. Fixed-price contracts also place more risks on the contractor for efficiency, thus leading the contractor to operate in a more economic manner. Further, FAR Subpart 16.301 on cost-reimbursable contracts states that those contracts should be used when appropriate surveillance will provide reasonable assurance that the contractor uses efficient methods and effective cost controls. Therefore, the DEF may have incurred lower costs if it had initially used a fixed-price contract to manage the fund.

Conclusion

In preparing the grant with the DEF, the Defense Nuclear Agency generally followed the terms of the Polish-American Enterprise Fund, a grant awarded under the SEED Act. Although following the terms of SEED Act grants was required under the National Defense Authorization Act for fiscal year 1994, doing so allowed the DEF to expend $2.2 million of grant funds for costs and expenses that would normally not be allowable under OMB Circular No. A-122. The unallocable, unallowable, and unreasonable expenditures made by the DEF and GPV to manage the grant support a continuing need to include Federal cost principles in contracts and grants that reimburse contractors and grantees for their costs.

Because the Defense Nuclear Agency was required to follow the terms of grants awarded under the SEED Act, and the DEF awarded a firm-fixed-price contract in October 1999 valued at $2 million a year to manage its investments, this report contains no recommendations.

Management Comments on the Finding

The Defense Threat Reduction Agency comments to the draft report emphasized that DoD does not control the Defense Enterprise Fund and stated that Congress declined to impose Office of Management and Budget and other regulations on the Defense Enterprise Fund. In addition, the Defense Threat Reduction Agency stated that absent specific language in 1204 of the National Defense Authorization Act for fiscal year 1994, the Defense Threat Reduction Agency would not have presented the grant for approval in its present form. Also, the Defense Threat Reduction Agency stated that the Defense Enterprise Fund was chartered to use grant funds to organize its management company and raise private capital. Finally, the Defense Threat Reduction Agency suggested that the lead sentence in the Executive Summary of this report state that the Defense Enterprise Fund used funds according to the terms of the grant.

Appendix A. Audit Process

Scope

Work Performed. We reviewed costs and expenses that the DEF incurred for Grant No. DNA001-94-J-0004 for fiscal years 1997, 1998, and 1999. To obtain background information on the grant, we reviewed the National Defense Authorization Act for fiscal year 1994 and applicable portions of the SEED Act, Grant No. DNA001-94-J-0004, and DEF policies, procedures, and manuals. To evaluate whether the terms of the DEF grant were as consistent as possible with grants awarded to enterprise funds established under the SEED Act, we compared the DEF grant with the grant awarded to the Polish-American Enterprise Fund. We also interviewed an official from the U.S. Agency for International Development to understand why SEED Act grants lacked the requirements included in OMB Circular No. A-122. To determine whether costs that the DEF incurred would have been deemed allowable or allocable to Federal awards, we compared selected incurred costs with OMB Circular No. A-122 and Part 31 of the FAR. We also traced selected expenses incurred by the DEF and GPV to supporting documentation, such as vendor invoices, airline tickets, and consulting agreements. Except for background materials and general ledgers from FY 1994 through FY 1996 and FY 2000 used to help total management costs, the documentation we reviewed covered the period from October 1, 1996, through September 30, 1999.

Limitations to Audit Scope. This review included several scope limitations.

- The review was limited to records that the DEF law firm submitted to our offices and to records that were available at the offices of Siguler Guff and Company, LLC, in New York City, New York. The review excluded any records in the Moscow, Russia, office of the fund manager. We understand that those records support whether the DEF and GPV exercised proper due diligence in making investment decisions.

- Staff of Siguler Guff and Company, LLC, destroyed an unknown quantity of records prior to the start of this review. We do not know if or how that affected the results of the audit.

- We did not ensure that all of the payments made to a DEF employee for paying DEF bills were properly accounted for because we did not have access to that employee's personal accounts.

- We did not ensure that all of the payments made to a Cyprus subsidiary of GPV to pay bills were properly accounted for because we did not have access to the subsidiary's accounts.

- We did not ensure that all property, plant, and equipment purchased with grant funds were properly accounted for because we did not have a list of GPV property, plant and equipment prior to the sale or disposition of those assets.

- We did not reconcile cash accounts in the DEF and GPV general ledgers to bank statements or review any cash reconciliations performed by independent public accountants for the DEF or GPV.

Methodology

We evaluated costs charged to the grant and included several areas.

- We reviewed the public law that required DoD to establish and award a grant to the DEF, and interviewed an official from the U.S. Agency for International Development to obtain an understanding of grants the agency awarded to enterprise funds through the SEED Act.

- We reviewed the grant awarded to the DEF and compared it to the provisions of the grant awarded to the Polish-American Enterprise Fund, a grantee under the SEED Act.

- We reviewed the internal corporate policies and draft policies of the DEF that we could locate. Also, we reviewed a draft GPV corporate policy for relocating employees. We also inquired of the grants office whether the Defense Threat Reduction Agency had approved any DEF corporate policy, which is a grant requirement.

- We reviewed paper copies of DEF and GPV general ledgers and traced entries to supporting documents provided by the DEF general counsel. In general, those documents included only the expense reports submitted by employees of the DEF and GPV and payroll ledgers for FY 1999. Later, we obtained additional documentation from the New York City office of Siguler Guff and Company, LLC. Documents obtained included documents that related to allegations made against DEF and GPV employees, petty cash records, and bills submitted by the DEF general counsel.

Use of Computer-Processed Data. We used the paper copies of the FY 1997, FY 1998, and FY 1999 general ledgers of the DEF and GPV to identify account balances and trace transactions. The general ledgers were created with commercially available software created by ACCPAC International, Inc. While supporting documentation was generally traceable to the general ledger, we are unable to fully evaluate the reliability of the data for several reasons. We did not evaluate the operating environment because GPV is no longer an active business. Supporting documents frequently did not identify how an entry was accounted for. When compared with the audited financial statements for

FY 1997, FY 1998, and FY 1999, significant differences existed between assets, liabilities, revenue, and expenses as shown in the general ledger.

Universe and Sample. We judgmentally selected transactions from records provided by the DEF General Counsel and from the records at the New York City office of Siguler Guff and Company, LLC.

Audit Type, Dates, and Standards. We performed this financial-related audit from November 2000 through November 2001 in accordance with generally accepted government auditing standards.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD, the U.S. Agency for International Development, the Office of Management and Budget, Siguler Guff and Company, LLC, and former employees of the DEF and GPV. Further details are available on request.

Management Control Program Review

We did not address the adequacy of the overall Cooperative Threat Reduction Program Directorate management control program in this report because it was addressed in the Inspector General, DoD, Report No. D-2001-074, "Cooperative Threat Reduction Program."

Prior Coverage

During the last 5 years, the General Accounting Office and Inspector General have issued two reports each discussing the DEF. Unrestricted General Accounting Office reports can be accessed over the Internet at http://www.gao.gov. Unrestricted Inspector General, DoD, reports can be accessed at http://www.dodig.osd.mil/audit/reports.

General Accounting Office

General Accounting Office Report No. OGC-99-61R, "Foreign Assistance: Issues Concerning the Polish-American Enterprise Fund," September 14, 1999

General Accounting Office Report No. NSIAD-97-101 (OSD Case No. 1308), "Cooperative Threat Reduction: Status of Defense Conversion Efforts in the Former Soviet Union," April 11, 1997

Inspector General, DoD

Inspector General, DoD, Report No. D-2001-074, "Cooperative Threat Reduction Program," March 9, 2001

Inspector General, DoD, Report No. D-2000-176, "Defense Enterprise Fund," August 15, 2000

Appendix B. Management Expenses By Fiscal Year

According to the general ledger trial balances of the DEF, between fiscal years ending September 30, 1994, and September 30, 2000, the DEF grant incurred $35.6 million of expenses to manage its investments. Primary expenses included management fees (31.9 percent), consulting expenses (18.5 percent), salaries and compensation (14.4 percent), and accounting, legal and professional fees (13.3 percent).

Defense Enterprise Fund Expenses Between FY 1994 and FY 2000

(thousands)

Expense	1994	1995	1996	1997	1998	1999	2000	Total	Percent of Total
Management Fees	-	-	-	-	$ 4,100.8	$4,800.0	$2,453.6*	$11,354.4	31.9%
Consulting Expenses	$ 42.2	$ 117.2	$ 400.5	$1,502.2	3,344.0	1,081.8	93.9	6,581.8	18.5%
Salaries and Compensation	23.4	700.0	1,033.1	1,926.6	1,455.4	6.4	-	5,144.9	14.4%
Accounting, Legal, and Professional Fees	-	533.6	1,515.6	1,036.9	608.2	727.0	334.5	4,755.8	13.3%
Office Expenses	14.7	259.1	369.6	1,098.8	789.9	242.6	20.8	2,795.5	7.8%
Travel, Meals, Incidentals, and Entertainment	5.2	223.1	293.1	874.9	747.4	34.4	3.8	2,181.9	6.1%
Rent and Repairs	1.2	66.0	164.9	442.6	188.9	-	528.7	1,392.3	3.9%
Depreciation and Amortization	-	25.7	105.1	159.4	32.1	310.4	9.5	642.2	1.8%
Employee Training and Fees	-	44.5	40.2	267.3	89.5	11.3	0.1	452.9	1.3%
Taxes and Licenses	26.6	36.8	44.0	77.2	95.4	-	26.9	306.9	0.9%
Other	-	15.4	77.5	(262.8)	55.5	354.5	(206.8)	33.3	0.1%
Total	**$113.3**	**$2,021.4**	**$4,043.6**	**$7,123.1**	**$11,507.1**	**$7,568.4**	**$3,265.0**	**$35,641.9**	**100.0%**

*Includes the cost of transitioning from GPV to Siguler Guff and Company

Appendix C. Expenses Related to Organizing Global Partner Ventures, LLC, and the NIS Transformation Fund

The DEF and GPV incurred at least $1.1 million of expenses associated with organizing GPV and operating the NIS Transformation Fund, a private equity fund. The expenses included costs to incorporate GPV as a limited liability company under the State of Delaware and prepare a private placement memorandum, a document used to raise funds from the public. If DEF were required to comply with OMB Circular No. A-122 and GPV required to comply with the cost principles in the FAR, expenses incurred to organize GPV and the NIS Transformation Fund would not have been chargeable to the grant. Specifically, OMB Circular No. A-122 and the FAR state that organizing and fund raising costs cannot be charged to Federal awards. Also, while other expenses associated with the private equity fund may be allowable under Federal contract and grant regulations, the expenses would have been unallocable because of the "consistency principle" in the regulations. To clarify, because the DEF accounted for similar type grant expenses, such as travel, rent, and accounting expenses as direct grant expenses, the grant would have been allocated a disproportionate share of expenses if the private equity fund were considered to be overhead expenses allocated to the grant. Nevertheless, costs of organizing GPV, preparing the private placement memorandum, and other related costs are allocable and allowable because the grant authorized the DEF to establish and finance other entities that make investments. Costs associated with establishing GPV and the NIS Transformation Fund between FY 1997 and FY 1999 are summarized on the following page.

Expenses Associated with Establishing GPV and the NIS Transformation Fund

Account No.	Account Name	1997	1998	1999	Total
5000-4	Salaries	-	$ 34,968	-	$ 34,968
5060-04	Recruiting	-	44	-	44
5065-04	Employee Insurance	-	4,391	-	4,391
5070-90	Employer Payroll Taxes	-	2,675	-	2,675
5550-04	401(a) Contribution	-	5,714	-	5,714
6100-04	Meals and Entertainment	$ 1,665	-	-	1,665
6120-04	New Business Development - non-travel	-	-	$ 743	743
6140-04-001	NISTF* Travel - Employee A	-	636	-	636
6140-04-011	NISTF Travel - Employee B	-	62,747	7,114	69,861
6140-04-012	NISTF Travel - Employee C	-	45,037	3,612	48,649
6140-04-013	NISTF Travel - Employee D	-	923	-	923
6140-04-019	NISTF Travel - Employee E	-	117	-	117
6140-04-021	NISTF Travel - Employee F	-	233	-	233
6140-04-023	Fundraising Travel - Employee G	-	953	-	953
6140-04-026	Fundraising Travel - Employee H	-	533	-	533
6140-04-030	NISTF Travel - Employee I	-	39,347	(3,347)	36,000
6140-04-033	Fundraising Travel - Employee J	-	175	-	175
6140-04-035	Fundraising Travel - Employee K	-	4,147	-	4,147
6140-04-044	Fundraising Travel - Employe L	-	175	-	175
6230-04	Depreciation Expense - Computers	-	1,277	-	1,277
6250-04	Depreciation Expense - GPV	2,341	741	-	3,082
6300-04	Telecommunications - GPV	1,406	6,247	-	7,653
6400-04	Postage and Mailing	-	252	-	252
6420-04	Office Supplies	5,936	2,265	-	8,201
6500-90	Accounting	2,538	-	-	2,538
6710-04	Training, Seminars and Memberships	10,693	1,448	-	12,141
6800-04	System Installation and Software - GPV	411	4,203	-	4,614
6800	Business Development and Fundraising	-	-	166,719	166,719
6900-04	Legal - Corporate - Private Equity Fund	77,792	56,678	-	134,470
7050-04	Delivery and Courier - GPV	262	74	-	336
7060-04	Director's Expenses - GPV	-	101	-	101
7100-04	Marketing - NISTF	-	273,938	60,464	334,402
7120-04	Presentation Materials	1,083	5,549	-	6,632
7140	Raising Private Capital	1,508	-	-	1,508
7200-04	Insurance Expense - GPV	-	90	-	90
7300-04	Dues and Subscriptions - Kiev	3,085	3,645	-	6,730
7301-04	Reference Material	-	53	-	53
7400-90	Consulting - GPV	75,331	89,354	-	164,685
7540-04	Travel - GPV	34,729	(3,070)	-	31,659
Total		**$218,780**	**$645,660**	**$235,305**	**$1,099,745**

*NIS Transformation Fund

Appendix D. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Policy
  Assistant Secretary of Defense (International Security Policy)
    Deputy Assistant Secretary of Defense (Negotiations Policy)
      Director, Cooperative Threat Reduction Policy
Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Director for Acquisition Initiatives

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Naval Inspector General
Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Threat Reduction Agency

Non-Defense Federal Organizations

Office of Management and Budget
Department of State
  Special Adviser for the New Independent States

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Efficiency, Financial Management, and Intergovernmental Relations, Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Relations, Committee on Government Reform
House Subcommittee on Technology and Procurement Policy, Committee on Government Reform
House Committee on International Relations
House Subcommittee on International Economic Policy and Trade, Committee on International Relations

Defense Threat Reduction Agency Comments

Defense Threat Reduction Agency
8725 John J. Kingman Road MSC 6201
Ft Belvoir, VA 22060-6201

DEC 20 2001

MEMORANDUM FOR DEPUTY DIRECTOR READINESS AND LOGISTICS SUPPORT DIRECTORATE, OFFICE OF THE ASSISTANT INSPECTOR GENERAL FOR AUDITING, DEPARTMENT OF DEFENSE

SUBJECT: Audit Report on the Management Costs Associated with the Defense Enterprise Fund (DEF) (Project No. D2000LG-0031.02)) (Formerly Project No. 0LG-5105)

The Defense Threat Reduction Agency (DTRA) is the office responsible for grants of DoD funds made to the DEF. The DEF is not a DoD Agency and is not under the direction, control or supervision of DoD. This written response is to submit management comments for the draft report.

The report states the DEF and Global Partner Ventures, LLC used grant funds for costs and expenses that were unallooable or unallowable under Federal grant or acquisition regulations, or considered unreasonable. Of the $35.6 million in expenses, the report states that at least $2.2 million was unallocable, unallowable, and unreasonable expenses under the Office of Management and Budget (OMB) Circular No. A-122.

To allow the DEF to fulfill its mission – to facilitate Defense conversion by investing funds through a corporation designed to mirror a private venture capital company – Congress, by statute, specifically declined to impose OMB Circular No. A-122 and other regulations like it on the DEF. The DEF and other Enterprise Funds are unique. They are governed by the legislation and grant agreements, which have at their core the expectation that they would function like venture capital companies.

Enterprise Funds were established under the Support for East European Democracy (SEED) Act, which makes it clear that the funds appropriated thereunder were to be made available "notwithstanding any other provision of law." In order to emphasize the private nature of the Enterprise Funds, the SEED Act states that "nothing in this section shall be construed to make an Enterprise Fund an agency or establishment of the United States Government, or to make the officers, employees, or members of the Board of Directors of an Enterprise Fund officers or employees of the United States for purposes of Title 5, United States Code." Thus, the DEF is regulated by internal documents typical of a private venture capital firm such as corporate by-laws, a statement of corporate policies and procedures, a corporate finance manual and the like.

If DTRA had been able to use accounting standards such as those established in OMB Circular No. A-122, DTRA would have had the necessary management tool - not currently available under the terms of the grant – to correct problems. Both the standard

and the management tools expressly contradict the intent of Congress to provide autonomy to enterprise funds.

The DEF is criticized for the expenditure of funds in connection with organizing its management company and raising private capital. Perhaps one half of the total funds with which the report takes issue were used for these purposes, although it should be noted that the DEF was chartered to engage in suoh activities and such efforts are consistent with the SEED Act.

Under normal circumstances, DTRA would not have issued this grant as it is written. In a June 1994 memo for the Assistant to the Secretary of Defense (AE), DTRA stated, "The established funds deviate significantly from some of the dictates of OMB Circular A-110 and, in some cases, from statutory requirements. We point out that, absent the specific language of Section 1204, this grant would not be put forth for approval in this form." As noted in subsequent correspondence, the Secretary of Defense "... concluded that it [grant DNA001-94-J-0004] should proceed as configured..." in accordance with the wishes of Congress.

DTRA understands the stated intent of the report is to provide lessons learned, but the report overlooks the most significant conclusion of the audit, in terms of DoD's limited responsibility for DoD funds provided to DEF. The Defense Enterprise Fund expenses were not found to be in violation of the terms of the grant. The grant is consistent with the SEED Act and the direction of the Secretary of Defense. This statement should be included as the opening sentence of the paragraph labeled "Results" on Page ii of the Executive Summary.

Robert P. Bongiovi
Major General, USAF
Deputy Director

Audit Team Members

The Readiness and Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report. Personnel from the Office of the Inspector General, DoD, who contributed to the report are listed below.

Shelton R. Young
Evelyn R. Klemstine
Donney J. Bibb
Michael T. Brant
Jaime L. Volturno